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ABBREVIATIONS USED

AV RL	State Holding Company
CAR	Capital Adequacy Ratio
CLF	Crédit Local de France
DEM	Deutsch Marks
DWIX	Index of Central Treasury Bond Yields
EBRD	European Bank for Reconstruction and Development
GNP	Gross Naitonal Product
HG	Housing Guaranty Loan Program
HUF	Hungarian Forint
K&H	Kerekedelmi és Hitel Bank (Commercial Credit Bank)
LCF	Loan Consolidation Fund
MBF Rt.	Magyar Befktétesi Fejesztesi Rt. (Hungarian Implementation and Development Company)
MHB	Magyar Hitel Bank (Hungarian Credit Bank)
MKB	Magyar Külkereseskedelmi Bank
MNB	Hungarian National Bank
MOF	Ministry of Finance
OTP	National Saving Bank
PIT	Personal Income Tax

ABSTRACT

This background paper assesses the current availability of credit to local governments in Hungary for the financing of infrastructure needs. Although levels of municipal investment are relatively low, loans represent only 10-15 percent of capital expenditures. Several factors have dampened the local decision to borrow. On the financial sector side, considerable nonperforming loan portfolios, central government deficit refinancing requirements, and the short-term nature of most deposits have limited capital available to local governments.

The National Savings Bank (OTP) holds almost all local governments accounts and handles the great majority of municipal lending. Nevertheless, several of the largest Hungarian banks have indicated interest in or are already pursuing a strategy of attracting local government business. Although local governments are perceived as an attractive market, some considerations have delayed the entry of banks, including the OTP's advantageous market position. USAID proposes technical assistance to banks and to municipalities to strengthen infrastructure finance capacities; in addition, it recommends renovation of central government investment subsidy system and improvement in the financial oversight of local governments.

EXECUTIVE SUMMARY

I. INTRODUCTION

The local government finance system has changed considerably in Hungary over the last ten years. While local governments have been granted far more freedom than they had in the past, many of their new powers, such as the levying of local taxes, remain unexercised. Local governments are now responsible for all investment decisions and, in addition, have to make up for a considerable deferment in capital development. Local governments still depend heavily upon central funding for infrastructure, but as those transfers do not cover the full cost of needed infrastructure investments, local governments are increasingly turning to loans to finance capital projects. This report examines the current status of lending to municipalities to determine whether local governments have access.

II. LOCAL GOVERNMENT BORROWING

Municipal Investment and Debt

Levels of municipal investment are considered to be low, at an average of 18 percent of total expenditures, and are pegged to State investment grant policy. At the same time, debt forms a relatively small portion of total budget and particularly capital revenues, when accumulated for all governments. According to the Ministry of the Interior and the National Savings Bank, in mid-1993, loans would represent about 1.5 percent of total expenditures and 10 to 15 percent of capital expenditures of local governments.

The Demand Side: Factors Affecting the Local Decision to Borrow

Despite the great need for finance to undertake necessary capital investments, there are several factors dampening local governments interest in borrowing. Uncertain property rights in the transitional period discourage investment. In Budapest, the added dimension of a division of ownership between city and district impedes cost recovery. Central budget subsidies discourage local governments from taking loans. Local governments are perceived to be unable to pay the cost of the loan; although the municipal sector is a stable part of the economy, their future has some element of uncertainty. Many local government managers have a conservative view of borrowing. The local decision-making process is too complicated, with power shared between the mayor and the assembly, and no important decision can be made without approval of the assembly.

III. INSTITUTIONS AND PROCEDURES FOR LENDING TO LOCAL GOVERNMENTS

The Hungarian Banking and Financial Sector

The largest Hungarian state-owned banks are faced with considerable nonperforming loan portfolios, due partly to the incapacity of bankrupt state-owned industries to meet their debt obligations. A Loan Consolidation Fund in 1992 was designed to inject capital into the banks, but this Fund did not fully address the nonperforming loan portfolio problem. A new bank consolidation program was implemented at the of end 1993, involving a three-pronged effort of debtor consideration, bank consolidation and bank recapitalization.

The main sources of funds for lending by banks appear to be customer deposits; due to the rate of inflation, which is still greater than 20 percent, these deposits are on a short-term basis. The only source for medium- to long-term funds at present are credit facilities extended by international banks. In 1993, a reduction in the household savings rate has reduced the banking sector capacity to extend credits. In addition, a tightening of monetary policy by the National Bank of Hungary in mid-1993 has led to an increase in interest rates. Thus, in the short- to medium-term, the increased cost of the few funds available for lending to local governments may also be a dissuasive factor.

At the end of 1992, over 50 percent of credits to Hungarian entities were lent to the Central Government, 34 percent to enterprises and 10 percent to households; although local government revenues represent over 20 percent of GNP, they receive only 1 percent of all bank credits to the Hungarian economy.

The Banks

The state-owned National Savings Bank (OTP) is the largest bank in Hungary. OTP holds almost all local government accounts and handles the great municipal lending. Borrowing by municipalities from OTP increased quickly in 1993 and outstanding loans at end of 1993 stood at HUF 20.7 billion, compared to HUF 12.7 billion twelve months earlier. OTP focuses primarily on the general financial health and the municipal budget in deciding when to lend to local governments.

Several of the largest Hungarian banks have indicated interest in or are already pursing a strategy of attaching local government business. These banks include: Budapest Bank, Kereskedelmi Bank, Magyar Hitel Bank, and Magyar Külkereskedelmi Bank. They are in different stages of elaborating specific policies and products to offer. Some of these products are services include: management of local government accounts, short-term lending, medium-term lending, issuance of municipal bonds, project finance, financial advisory services and portfolio management services.

Municipal Bonds

An initial council bond market developed in the 1980s; after an inflation-related hiatus, five state-guaranteed municipal bonds were issued in April 1992. Since then, municipal bonds have been issued with only the guarantee of the municipality. All new issues of municipal bonds have been private placements. Bonds now seem to represent at least 10 percent of local government debt and are used nominally for financing infrastructure development. Motivations for recourse to bond finance may include palliating the current lack of bank lending, to serve as an alternative to OTP lending and as a source of lower cost capital.

IV. PROSPECTS FOR EXPANSION OF MUNICIPAL LENDING

Capital lent to and issued by municipalities represents a small fraction of capital needs although local governments are generally perceived as an attractive market. One sizeable restriction to entry by new banks is the well-entrenched near monopoly held by OTP. While major Hungarian banks have expressed interest in lending to municipalities, most emphasized the connection between lending to local governments and capturing the bank accounts of these clients.

For banks to complete effectively with OTP, they must make major investments in computer programs, develop services and products, and train staff in order to credibly manage local government accounts. Loans could be associated with project analysis and feasibility advice. There are indications that local governments are seriously looking for alternatives to current arrangements, and many speak of the unacceptability of OTP loan terms and the rigidity of their conditions.

V. CONCLUSION: PROBLEMS AND RECOMMENDATIONS

The current situation presents a puzzle: local governments borrow very little, everyone agrees they are creditworthy clients; however; banks do not seem to be aggressively pursuing the market. Municipalities themselves are often cautious about borrowing for various reasons including lack of experience and expertise and fear of income instability or decline. Hungarian local governments are not required by law to limit their borrowing to a certain percentage of their budget and should a local government default on a loan, priority use of available finances is given to operating expenditures.

Role of USAID Capital and Technical Assistance

USAID has already begun a program of technical assistance to local governments in several areas related to municipal finance. While banks are interested in entering the sector, they will need some help to enhance their ability to improve municipal finance and project analysis capabilities. USAID ongoing technical assistance in infrastructure finance should be broadened to address capital planning, capital budgeting, project preparation, cost recovery and local tax base estimation. Another area that could benefit from analysis and possible technical assistance is the current system of central government investment grants, which has a number of problems. Finally, recommendations should be made at the national level regarding the scope and quality of financial oversight of municipal accounts and practices and regulation of the municipal bond market.